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Bond investors cool to fund buyout boom

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The buyout boom that helped fuel Wall Street's recent record rise may be stalling now that debt investors who helped finance that surge are starting to turn away.

It's about time. Bondholders had long put themselves at risk by funding private-equity acquisitions that gave them few protections and seemed to put the sellers' interests first. Now they want more for their money, as seen by their recent demands for better terms in some big transactions.

No doubt that investors have been rattled by the unraveling of other risky debt, namely the near-collapse of two Bear Stearns hedge funds that had big holdings in subprime mortgages. That came as interest rates here and abroad have been rising, thereby increasing the cheap borrowing costs that have been the lifeblood of the recent takeover frenzy.

Corporate acquirers and buyout firms have capitalized on low rates and the global liquidity boom to finance acquisitions with huge sums of debt in addition to the limited amounts of cash they had to put up. The lower debt expenses go, the more private-equity firms stand to profit. Exhibit A is the $2.27 billion in net income reported by industry giant Blackstone Group for 2006.

But the tide has definitely turned. Investors have begun to balk at taking on risky debt. They aren't jumping into offerings as they were just months ago, and they are demanding better performance from the companies, less flexibility on the part of borrowers and higher interest rates.

"The buyers of debt are saying that things have just gone too far," said Kingman Penniman, who heads the Montpelier, Vt., bond research firm KDP Investment Advisors, Inc.

Since March, 19 companies have agreed to add covenants to their loan deals that prevent them from making financial or operation changes without investor consent, according to Standard & Poor's Leveraged Commentary & Data.

In the last week or so, the trend has become more pronounced, starting with the troubled bond sale to fund the $7.75 billion buyout of Thomson Corp.'s Thomson Learning unit by Apax Partners Worldwide and OMERS Capital Partners, a Canadian pension plan.

In response to investor concerns, the company cut the size of its debt offering to $1.6 billion from $2.14 billion. It eliminated a proposed $540 million "payment-in-kind" floating rate note, which would have allowed it to pay interest in additional bonds rather than cash. It also boosted the covenants on the loan portion of the deal, according to KDP.

Late Tuesday, underwriters scrapped a large bond and loan offering that was intended to back the $7 billion buyout of Royal Ahold's U.S. Foodservice by Kohlberg Kravis Roberts and Clayton, Dubilier & Rice. Already, the deal had been restructured twice to appease investors' demands, but that still didn't get it to the market.

As part of the changes, $900 million had been shifted away from the deal.

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